

TEACHERS' RETIREMENT BOARD  
SUBCOMMITTEE ON CORPORATE GOVERNANCE

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SUBJECT: Corporate Governance Issues

ITEM NUMBER: 4

- Enron Related Corporate Governance issues
- Deferred Compensation Plans Regarding Portfolio Companies
- Work plan Discussion

ATTACHMENTS: 5

ACTION: X

DATE OF MEETING: March 6, 2002

INFORMATION:     

PRESENTERS: Elleen Okada/Janice Hester Amey

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**EXECUTIVE SUMMARY**

• ***ENRON RELATED CORPORATE GOVERNANCE ISSUES***

**Background**

Although CalSTRS is not subject to the Employee Retirement Income Security Act (ERISA), the strictures of Proposition 21 established identical standards for its investment process. The ERISA prudent expert standard, combined with the statutory obligation found in the Teachers' Retirement Law, make it clear that CalSTRS commitment to Corporate Governance is no more than a diligent exercise of its fiduciary responsibility. The statutory requirement regarding Corporate Governance does not permit the Board to abrogate its exclusive authority and responsibility with respect to proxy voting. The ERISA standard regarding proxy voting and corporate governance is equally strict:

“In general, the fiduciary act of managing plan assets which shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department's position that the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management...”<sup>1</sup>

CalSTRS has a long history of involvement and leadership on Corporate Governance matters. Soon after CalSTRS and CalPERS became two distinct organizations, CalSTRS increased its allocation to public equity and its reliance on passive investment management. CalSTRS' long-term objectives are illustrated through its substantial commitment to passively managed portfolios in the two largest asset categories for the fund: Domestic Equities and Fixed Income. CalSTRS' commitment to the long-term investment approach was rooted in its status as a defined-benefit plan and the recognition of the significant unfunded liability in the plan at the time. It was clear that the unfunded liability could not be entirely offset by investment performance; it was also clear that the level of the liability could be ameliorated by investment returns.

(1) Department of Labor Advisory Bulletin on Proxy Voting by Plan Fiduciaries dated February 23, 1988, sent to Avon Products, Inc.

Directors are the only ones in the corporate pyramid that have a fiduciary duty to shareholders. CalSTRS has been concentrating its efforts on empowering the Corporate Board of Directors to act in the best interests of shareholders. Since 1982 CalSTRS has, and continues to favor independent review committees such as Audit, Nominating and Compensation, and CalSTRS favors a non-executive chair of the Board.

The Enron failure raises many issues, but for shareholders, the most important may well be the failure of the Board of Directors to act in the best interests of shareholders. Whenever any management presents a scheme that puts its interests ahead of that of the shareholders, the Board of Directors should resolve the conflict in the shareholders' favor. It appears that the Enron Board suffered from cronyism and a complete disregard for the fact that the capital that was invested in the company belonged to shareholders. Some investors have addressed the issue of board oversight and have decided to make this issue a focal point of its efforts in the coming year. CalPERS approved several recommendations at its meeting on February 21, 2002, among them:

- Pursue Market Level Reforms addressing Audit Committee Competence, Auditor Independence, Director Independence, and Accounting Industry Oversight;
- Support legislative efforts to revise rules regarding 401(k) plans;
- Super-impose these concerns onto specific companies.

A detailed list of all the issues raised thus far is attached and labeled as Attachment 1A.

There appear to be several facts that may have compromised director independence on the Enron Board. Although the Enron 2001 proxy statement showed that two-thirds of the Board was independent and did not need to disclose ties, it now develops that at least three of the eight had significant ties to Enron that could compromise their independence:

- A member of the audit committee is also president of the University of Texas M.D. Anderson Cancer Center. The Center received significant support from both the corporation and its CEO, Kenneth Lay.
- Two directors own units in one of Enron's energy partnerships, a limited partnership whose general partner is a wholly owned subsidiary of Enron. One of these members served on the finance committee, while the other served on both the audit committee and the compliance committee.
- Another member of the audit and compliance committee served as a director of a university center that was the recipient of substantial funds from Enron.

### **Recommendation**

Staff believes that all of the above actions are appropriate and within the scope of the Corporate Governance effort at CalSTRS. Due to time and resource factors, staff believes the immediate focus should be narrowed. Staff recommends that CalSTRS focus and devote our resources to pursue these main issues: Audit Committee responsibility and competency, Director Independence, Auditor Independence and increasing disclosure regarding Executive Compensation and Director ties. If approved staff will present an implementation plan on these issues at the April or May meeting.